(916) 323-7712

April 7, 1982

Dear

This is in response to your letter of March 5, 1982, regarding the development of the capitalization rate for valuing various federally subsidized housing projects. This response will address only the issue of whether the provisions of Section 402.9 of the Revenue and Taxation Code are applicable to projects under Sections other than 236 of the National Housing Act.

As you may be aware, the Attorney General issued an opinion in 1976 (No. CV 75/267; 59 Cal. Ops. Atty. Gen. 293) which concluded that the federal interest subsidy under the Section 236 program "is properly includable as a portion of the future income to be derived from the property in question." (at pg. 297) Apparently in response to this opinion, Section 402.9 was enacted in 1978 (SB 1706, Chapter 737). This section provides, in part, that "In valuing property...which is financed under Section 236 of the federal National Housing Act,...the assessor shall not consider as income any interest subsidy payments made to a lender on such property by the federal government."

Since Section 402.9 specifically names only the Section 236 program, it is our opinion that it does not apply to any other federal interest subsidy programs including Sections 231 and 221(d)3 projects. Since these projects were in existence at the time Section 402.9 was enacted, we can only conclude that they would have been specifically named in the statute if the Legislature had intended that they too were to be included. This conclusion is based on the Legislative history of Section 402.9. As originally introduced on March 13, 1978, SB 1706 provided that interest subsidy payments would be excluded in valuing low and moderate income housing projects financed under any federal program. The bill was later amended to limit its application to only Section 236 projects.

It should be noted that to the extent that Sections 231 and 221(d)3 projects are restricted to persons of low and moderate income, such restriction would be reflected in the value of the project as provided in Section 402.1 of the Revenue and Taxation Code.

I trust this is responsive to your inquiry. If we may be of further assistance to you in explaining more specifically the development of the capitalization rate for Sections 221(d)3, 231 and 236 payments, please contact this office and I will refer your request to our Assessment Standards Division.

Very truly yours,

Margaret S. Shedd
Tax Counsel

MSS:jlh

bc: Mr. Monte Fuller
Sacramento Deputy County Counsel

Mr. Gordon P. Adelman
Mr. Robert H. Gustafson
Legal Section

(916) 445-4982

April 2, 1982

Honorable David W. Wynne
Assessor/Recorder of Tuolumne County
Administration Center
No. 2 South Green Street
Sonora, California 95370

Attention: Ken Caetano
Chief Appraiser

Dear Ken:

After reviewing your January 22, 1982 letter and accompanying materials dealing with Farmers Home Administration Section 515 subsidized apartment houses, our legal staff has concluded that Revenue and Taxation Code Section 402.9, which excludes from the calculation of income of Section 236 housing the interest subsidy paid on the owner's behalf by the federal government, does not apply to subject property or any other property subject to the restriction of the FmHA Section 515 program. Other special subsidy programs, such as the FmHA Section 515, had been enacted and were known to the Legislature at the time that Section 402.9 was enacted. If the Legislature had intended Section 402.9 to apply to programs other than FHA Section 236, it could have provided for this in the wording of the Code Section. The fact that it did not is strong evidence that this restriction is limited to FHA Section 236 housing.

However, Section 402.1 (b), which includes as enforceable restrictions "recorded contracts with governmental agencies other than those provided in Section 422," would seem applicable to FmHA Section 515 projects. Any effect upon value that such enforceable restrictions might have should be reflected in the full cash value of the apartment project. What this effect might be is a matter of appraisal judgment which must be determined by your staff.

Thank you for your patience in awaiting an answer from us on this topic. We hope to hear from you again soon.

Sincerely,

Verne Walton, Chief
Assessment Standards Division

VW:bjb
AL-08-1352A

bc: Mr. Glenn Rigby
Mr. Don Ide

(Prepared by: Pete Gaffney)

Board of Equalizatior

andum

Glenn L. Rigby Date : March 12, 1982

Karen Smith

: Farmer's Home Administration 515 Apartment Projects

An Attorney General Opinion (No. V 75/267 dated April 21, 1976) concluded that the federal interest subsidy under the Section 236 program "is properly includable as a portion of the future income to be derived from the property in question." However, Section 402.9 of the Revenue and Taxation Code (enacted in 1978) provides that "In valuing property . . . which is financed under Section 236 of the Federal National Housing Act, . . . the assessor shall not consider as income any interest subsidy payments made to a lender on such property by the federal government."

Since Section 402.9 specifically names only the Section 236 program, it would appear that it would not apply to any other federal interest subsidy programs including Section 515 and all other similar ones. Since they had been enacted and known to the Legislature when Section 402.9 was passed, it appears that if the Legislature would have wanted Section 402.9 to apply to all of these programs, they would have been mentioned or Section 402.9 would not have been so limiting in its application.

In light of the Attorney General's opinion and analysis and the restrictive language of Section 402.9, it appears that any programs that deal with the same type of interest subsidy as Section 236 are not subject to the prohibitions from including subsidy payments as income found in Section 402.9.

The Section 515 program is essentially the same as Section 236 except it applies to rural areas rather than urban areas. Therefore, under the Attorney General's analysis Section 515 subsidy payments can be properly included as income to be derived from the property in question.

KS:jlh

Board of Equalization

..ndum

:. Verne Walton

Date : March 26, 1982

RECEIVED
MAR 29 1982
Division of Assessment Standards
SACRAMENTO

From : Glenn L. Rigby

Subject: Farmer's Home Administration 515 Apartment Projects

Attached for your reference is a memorandum prepared by Karen Smith, a legal intern in our office, regarding the question of whether or not Section 402.9 of the Revenue and Taxation Code is applicable to 515 apartment projects. As you can see from the attached memorandum, we have concluded it is not.

Although it is incongruous to appraise properties subject to similar restrictions differently, we should, nevertheless, advise the Tuolumne County Assessor that Section 402.9 is inapplicable to the subject projects.

However, Section 402.1(b) would appear applicable and to the extent that the contract with the government keeps rental down, the appraised value should reflect this fact.

There is one point that I think you should give some thought to. It seems to me that the inclusion or exclusion of the mortgage interest subsidy in the income to be capitalized may not result in a different value, since the risk component of the capitalized rate may act as an equalizer. Since I am not an appraiser, I will leave this point in your hands.

Glen

GLR:jlh

Attachment

cc: Mr. Gordon P. Adelman w/att.
Mr. Robert H. Gustafson w/att.
Ms. Margaret S. Shedd w/att.
Legal Section w/att.

State of California Board of Equalization
Legal Division

Memorandum

To: Mr. Richard Johnson
Mr. Mark Nisson

Date: July 17, 1998

From: Kristine Cazadd
K. Cazadd

Subject: Valuation of Low Income Housing Projects

This is in response to your June 29, 1998 request for research and analysis of the legal issues pertaining to the valuation of low income housing. Please see the following in regard to answering the specific questions to be addressed. We recommend that a new letter to assessors be issued on this topic.

1. What are the legal parameters of the 515 program and the 236 projects under the federal law and should they be treated the same for property tax valuation purposes.

The low income housing programs constituting the subject of this inquiry were originally enacted and amended by the U.S. Congress at different time periods and under different enforcing agencies. The program characterized as "Section 235 and 236" housing was created under the 1968 National Housing Act as a means of providing government support, financing, insurance, accelerated depreciation, and preferred returns on equity to private corporations/entities, quasi-governmental agencies, and nonprofit organizations which construct and operate low income housing projects. The Department of Housing and Urban Development (HUD) is the supervising agency, with local housing authorities also having substantial power to determine the location, design, selection of contractor, and other matters pertaining to the development of these housing projects.

The program characterized as "Section 515" housing was created under the Housing Act of 1949 as a means of providing government support, financing, insurance, accelerated depreciation, low cost loans, and other benefits to private developers, quasi-governmental agencies, and organizations which construct low income housing under urban renewal and to fill the post-war housing shortage. The Farmer's Home Administration is the overseeing agency.

Regardless of origin or of the oversight agency however, the determination of whether the owners of these and other low income housing projects will receive any available tax credits, benefits, and incentives is now made by the Internal Revenue Service. In revamping the system and repealing former tax shelter and deduction provisions in 1986, Congress brought all low income housing projects under Section 42 of the Internal Revenue Code as part of the Tax Reform Act of 1986. The purpose of this section was to give private equity investors valuable

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tax incentives in return for spending their money to build the needed amount of low income rental housing units in specific locations and to operate such housing units for a long enough time period, e.g. 15 years, the "compliance period." The tax credit system established in Section 42, authorizing low income housing credit ("LIHC") is the sole method adopted by Congress to accomplish this objective. Since that time, the IRS has authority to qualify (or to deny) numerous types of housing programs under Section 42, in addition to those mentioned above. Some of these are Section 8 and Section 221(d) HUD programs and Section 502(c) FmHA programs.

Thus, the main issue, for property tax valuation purposes, is not so much the type of housing project, but whether and to what extent the project being appraised qualifies for the LIHC under Internal Revenue Code Section 42. The availability and amount of LIHC is the foundation for encouraging investors to participate in these projects, because it is specifically designed to compensate the investors for receiving little or no cash flow due to reduced rents from low income tenants for the 15-year period. Under IRC Section 38, a credit (LIHC) against the taxpayer's net income tax shall be allowed for his/her investment in low income housing under Section 42(a). As such, LIHC is the basis for calculating the internal rate of return for the investors in any given project.

The following discussion summarizes the parameters of LIHC and its effect on the value of a project in detail.

2. What is the criteria for and extent of LIHC for qualified low income housing projects under IRC Section 42?

a. Basic summary of criteria for and extent of LIHC.

As enacted, the amount of LIHC for any qualified low income building in a taxable year in the credit period is an amount equal to the applicable percentage of each qualified low income building. This applicable percentage is generally 70 percent value credit for new buildings and 30 percent value credit for certain older buildings, unless substantially rehabilitated. The tax credits (LIHC), taken over a period of 10 years (the 10-year credit period) are available only for buildings that retain their low income status for a minimum of 15 years (the 15-year compliance period). Although numerous modifications to certain aspects of the LIHC system have occurred, the Revenue Reconciliation Act of 1993 permanently extended LIHC indefinitely.

b. Projects and Buildings which qualify.

LIHC is available only to owners of a "qualified low income housing project" or a "qualified low income building." A "qualified low income housing project" is one which is "residential rental property" (as defined in IRC Section 103), some or all of which meets the low income set-aside requirements under IRC Section 42 (g)(1). Unlike projects or buildings financed with tax exempt rental housing bonds, a "qualified low income housing project" may include numerous buildings, residential hotels (even though dining and other activities are included), and projects with functionally related and subordinate facilities (recreational, parking and laundry facilities) as long as no fees are charged, or fees are refunded to the residents at the end of their lease.

A "qualified low income building" is one which during the 15 year compliance period is part of a "qualified low income housing project" and is subject to the depreciation schedules under IRC Section 42(c)(2), (usually the 27.5 year straight line schedule). A "qualified low income building" may include an apartment building, a single-family dwelling, a townhouse, rowhouse, duplex, manufactured housing affixed to real property, or a condominium. It does not include projects or buildings receiving assistance under Section 8 (e)(2) of the Housing Act of 1937, or under the Homeless Assistance Act of 1988, or benefits under a cooperative housing or tenant stockholder corporation.

c. Low Income and Rent Restriction Requirements.

IRC Section 42 establishes that a minimum number of units are (i) rent restricted and (ii) occupied by low income tenants during the 15 year compliance period. Thus, in order for a low income housing project to qualify for LIHC, one of two tests must be met. First, at least 20 percent of the project must be occupied by households with incomes at or below 50 percent of the area median income; or, secondly, at least 40 percent of the project must be occupied by households at or below 60 percent of area median income. It is important to note that rents paid by tenants in low income units are restricted to 30 percent of the qualifying tenant income (i.e., 50 - 60 percent of the area median income) including utilities.[1]

A housing unit is considered "low income" if: (1) occupied by tenants with incomes meeting designated income requirements (at or below 50 - 60 percent of the area median income; (2) its rent is restricted; (3) the unit is suitable for occupancy; (4) the unit is not used on a transient basis (less than 6 months); and (5) the occupants are not all students. The income limit established by HUD and approved by the IRS for a given period must be met at the time the low income housing project or building is placed in service. Thus, a decline in the are median gross income after the date the limit is established will not require a further reduction in rent.

In regard to the rent restrictions, the gross rent paid by the tenants in the low income units may not exceed 30 percent of the qualifying income standard applicable to that project or building (i.e., 50-60 percent of the area median income). To provide project owners with certainty that the rent will be received, IRC Section 42 (g)(2)(C) provides that the rent restriction is based on

[1] IRC Section 42 (g)(2).

the number of bedrooms, rather than the number of persons, occupying the unit and the imputed income limit applicable to that unit (with respect to the LIHC credit allocated).

Each state is assigned a limited amount of LIHC for allocation among housing projects. State and local housing credit agencies are authorized to allocate credits for that state, and only to projects where the housing owner commits to providing long-term, low income housing. In California, the amount of credit allocated to any housing owner must be authorized by the California Tax Credit Allocation Committee, and is based on the project's need for the credit in order to be economically feasible. Except for projects or buildings financed with certain tax-exempt bonds, numerous types of low income housing projects may qualify, but only those with allocated credit under Section 42 are entitled to LIHC.[2] Buildings not eligible to receive credit allocations after 1989, may qualify however, if an "extended low income housing commitment" (in the form of an agreement) is executed between the taxpayer and the allocating agency. The agreement/commitment sets forth the compliance requirements (discussed below) and is binding on all successors (potential buyers).

d. Determining the building's LIHC - "Eligible basis of building costs" and "Qualified basis attributable to low income units."

The availability and size calculation of the LIHC is extremely important, because it determines the equity investment that can be raised for a given project. The predominant benefit to the investor in such projects is the tax savings resulting from the credit itself. Since investors will rarely receive any cash flow, the LIHC and some tax losses are the sole components of the investors' return of or on his investment, i.e., his yield. LIHC is calculated on the following three factors: (1) the "eligible basis" of building acquisition or construction costs; (2) the "qualified basis" attributable to the low income units, and (3) the annual LIHC based on the qualified basis and applicable credit percentage, together with the LIHC proration during the first year of the credit period.

(1) Eligible Basis: The "eligible basis" of a newly constructed building or of an existing building that is "substantially rehabilitated" is its adjusted basis attributable to acquisition, rehabilitation, or construction costs for the entire building (not merely the low income units). Its adjusted basis reflects the costs before first-year depreciation of the building, (usually at the end of the first taxable year of the 10-year credit period). For *existing* buildings allocated credits after 1989, the eligible basis is zero, except in certain situations where, for example, the building is substantially rehabilitated, or is acquired by purchase, or was not previously placed in service during the past 10 years. For *new or substantially rehabilitated* buildings after 1989, the LIHC eligible basis is 100 percent of the cost.[3] An added tax benefit is that the

[2] See IRC Sec. 42(h)(6) and (h)(4).
[3] There is an exception under IRC Section 42(f)(5)(B) for certain acquisitions of older, federally assisted buildings not substantially rehabilitated.

eligible basis for *new buildings in "high cost areas"* (designated by HUD as "difficult development areas") may be increased by 30 percent, that is up to 130 percent of the building's cost.

The eligible basis of a building must be reduced however, by the amount of any federal grants made to a project within the 15-year compliance period. Similarly, the eligible basis is reduced by an amount equal to the outstanding balance of any federally subsidized loans ("interest subsidies" per Section 402.9) related to construction or rehabilitation, if the project owner wishes to take the 70 percent present-value LIHC. Thus, once the "eligible basis" of a building is established, it cannot increase, but it may decrease if such federal grants or loans are received. The owner's remedy is to elect to reduce the building's eligible basis by the amount of the federal subsidy and use the higher applicable percentage for the remainder of the eligible basis. [4]

(2) Qualified Basis: The qualified basis of a building is the fraction of the building's eligible basis that is "attributable to the low income units." The qualified basis is then multiplied by the applicable LIHC percentage, in order to calculate the LIHC amount each year. [5]

The qualified basis calculation is based on the lesser of (i) the "unit fraction," which is the ratio of the number of the occupied low income units divided by the total, or (ii) the "floor space fraction," which is the ratio of the floor space of the occupied low income units to the total floor space of the rental units in the building. As noted above, a "low income unit" is any rent-restricted unit occupied by tenants meeting the income limitation for that unit.[6] As an example, if the eligible basis of a building's cost is $200,000, and 50 percent of the units are occupied by low income tenants, and the floor space of these low income units is 45 percent of the total floor space for all units, the "qualified basis" is $90,000 (which is the lesser of 50 percent or 45 percent, times the eligible basis).

While the "qualified basis" is based on the units actually occupied by low income tenants in the first taxable year that the building is placed in service (usually on the last day of the first year), it must be maintained continuously during the 15-year compliance period in order for the LIHC to be allocated over the full 10-year period. The "qualified basis" in the building may be increased in subsequent years, if additional units become low income occupied, or if the floor space of low income units is increased. When such increase occurs, the LIHC is claimed for the added qualified basis at a different rate.[7]

[4] See IRC Section 42 (i)(2).
[5] IRC Section 42(a).
[6] IRC Section 42 (i)(3)(B)(ii).
[7] IRC Section 42 (f)(3)(A)(i).

(3) Annual LIHC based on the qualified basis and applicable credit percentage, with the LIHC proration in the first year claimed.

The actual amount of LIHC is calculated by multiplying the qualified basis attributable to the low income units in a building by the applicable LIHC "credit percentage" allocated to the building (through the authorized credit agency). For buildings placed in service in 1987, the maximum credit percentage is either 9 percent annually for 10 years (i.e., total LIHC of 90 percent over 10 years), or 4 percent annually for 10 years (i.e., 40 percent over 10 years). The 9 percent LIHC is available for new construction and substantial rehabilitation costs, while the 4 percent is available only for building acquisition and substantial rehabilitation costs.

For post-1987 buildings, the 9 percent (for new construction and substantial rehabilitation) and 4 percent (building acquisition and substantial rehabilitation) annual LIHC credits are adjusted so that the present value of the credits taken over 10 years equals 70 percent and 30 percent respectively. Similarly, for buildings placed in service after 1989, the 70 percent present- value credit is available for new construction and substantial rehabilitation costs allocable to 1 or more low income units which meet the requirements, and the 30 percent is available for building acquisition and substantial rehabilitation costs within the criteria.

The amount of LIHC in the first year claimed is based on the number of months the low income units are occupied. This first-year proration also applies to LIHC for the qualified basis added after the first year. Any unused portion of the first year's credit for the additional qualified basis may not be recovered subsequently.

e. Disallowance of the Credit.

There are several limitations on the allowance, timing and amount of LIHC allocated to and useable by every project.

(A) During the first year, any LIHC is disallowed (and must be adjusted) for any months that the low income units were not occupied.

(B) No LIHC is allowed if the owner of a qualified project does not have an allocation from, or a binding commitment with, the state's housing credit agency. Once the credit is so authorized, the LIHC for that project is limited to the amount allocated. There is a special exception for owners of projects where at least 50 percent of the land and building is financed by tax-exempt bonds, in which case an allocation of LIHC may be made by the supervising federal agency.

(C) LIHC may be claimed only during the 10-year credit period designated for that project, beginning with the first year the building is placed in service or in the second year, if the owner has made the election to do so.[8]

(D) Noncompliance with the 15- year compliance period occurs because low income occupancy is not maintained continuously throughout this period (starting at the beginning of the first year of the LIHC credit period). Noncompliance means low income units are rented to non-low income tenants. Noncompliance triggers a recapture of the LIHC, discussed below.

d. The Recapture of LIHC and Penalties.

As previously noted, the qualified basis for LIHC must be maintained throughout the 15-year compliance period, beginning on the first taxable year in which the LIHC is claimed, even though the LIHC is taken over a 10-year period (referred to as the "accelerated portion" of the LIHC). If a compliance failure occurs during the 15-year period, it triggers recapture of the accelerated portion of the LIHC during the 10-year period. When recapture is triggered, no LIHC is allowed for that year. Thus, the owner must pay recapture on the disallowed LIHC and accrued interest, which is not deductible.

Some of the events which trigger non-compliance and recapture are: (i) failure to rent qualified low income units to low income tenants; (ii) a complete or partial change in ownership within the 15-year compliance period, unless the seller posts a bond satisfactory to the IRS (usually equivalent to the total credits claimed by the owner) and produces evidence that the building will meet the low income occupancy requirements for the remainder of the period; (iii) a federal subsidy is used to refinance the building; and (iv) failure to restore or reconstruct within a reasonable time, any portion of the building damaged or destroyed by a casualty loss. In virtually all cases, the owners take every step necessary to avoid recapture of any LIHC, including in change in ownership transactions posting the necessary bond and insuring that the new owner will receive the same qualified basis, LIHC percentages, and remaining compliance period as the original owner.

3. To what degree does LIHC have an effect on the valuation of the property?

a. Value of the Tax Credits.

As discussed above, Congress was fully aware of the fact that the low rents needed to achieve the targeting level of the low income tenants would not be able to support the full amount of

[8] LIHC is claimed by the owners filing Form 8586 (Low Income Housing Credit). The annual statement filed with the IRS (in addition to the owners tax return) is Form 8609 (Low Income Housing Credit Allocation Certification), which is used to obtain the housing credit allocation.

the mortgage financing and construction costs. Thus, the primary purpose of the tax credit system in IRC Section 42 was to make the LIHC "sufficiently generous to offset the effect of these low rents".[9] Although no credit is allowed on the land, the amount of allocated LIHC on the building directly relates to the rate of return or yield that the investors expect to receive for their investment in the building and its operation.

The amount that a willing buyer would pay for such a project depends in large part on the credit itself. The rate of return for the investor in a low income project is composed of three major items: (a) the LIHC, (b) any cash flow from the operation and/or sale of the project, and (c) the tax benefit (cost) of taxable losses (income).[10] Since the major tax benefit is the LIHC, projects which have received less credits, will produce less in investor yields. For example, in projects constructed or operated with proceeds from a tax exempt bond, less than half of the tax credits are allocated than in projects built with taxable bonds. Unless tax losses related to that low-credit project are increased, the yield to investors will be reduced, thereby reducing the attractiveness and value of the project in the marketplace. A popular way of increasing the tax credits available for a tax-exempt bond project is to utilize the building rehabilitation credit (IRC Section 47 - tax credits for costs of restoring or rehabilitating historic buildings) and the low income housing credit (LIHC) in tandem, in which case the net tax benefits achievable by combining the two can exceed the benefits of using either alone. As an example showing the value of the credits taken together and taken individually, see the attached appendix A.

b. Application of Revenue and Taxation Code Sections 402.1 and 402.9 to Projects with Allocated LIHC.

In previous letters to assessors the Board staff has advised that pursuant to the relevant Revenue and Taxation Code provisions above, low income housing projects financed under (HUD) Section 236 of the National Housing Act are (1) restricted properties within the meaning of Section 402.1 and should be valued as such, (2) that the income approach is the preferred valuation approach for these properties, and (3) the band-of-investment method is the appropriate method for deriving the capitalization rate. Beginning in September 1979, assessors were advised of legislation codified in Section 402.9 stating that in determining the income to be capitalized when valuing these properties, "the assessor shall not consider as income any interest subsidy payments made to a lender by the Federal government" for financing such projects (in the form of low cost loans).[11]

Recently, the First District Court of Appeal issued a decision in *Mission Housing Development Company v. City and County of San Francisco* (1997), 59 Cal.App.4th 55, stating in part that

[9] "Tax Management Multistate Tax," Portfolio No. 477, p.A-27.
[10] "The Tax Magazine," July 1997, *Cost Segregation Studies Improve Investor Yields in Low Income Housing Tax Credit Projects*, Michael J. Novogradac, CPA.
[11] Letter to Assessors No. 79/37, p. 1.

the assessor's reliance on the band-of-investment method for deriving the applicable capitalization rate is proper, and that the inclusion or exclusion of interest subsidies (per Section 402.9) is entirely irrelevant when using this method. At issue in the valuation aspect of the case were the two different methods of deriving the capitalization rate under Rule 8 (g) in regard to the valuation of several "Section 236" low income housing projects financed in part by low interest loans from HUD.

The project owners (taxpayers) sought to prove that the band-of-investment method was arbitrary and violated standards prescribed by law. In this regard, taxpayers contended that the assessor (1) failed to discount assumed mortgages to their cash equivalents, and (2) erred in determining the applicable capitalization rate. Responding to the first contention, the court held that Rule 4, in requiring the use of the comparable sales approach, is not applicable when the assessor is using the band-of-investment method governed by Rule 8, since Rule 8 does not require discounting mortgages to cash equivalents. As to the second contention, the court held that the requirement under Section 402.9, to convert to a cash equivalent any interest subsidies and exclude that amount from the income stream, is also not applicable, since it is only relevant where the comparable sales method is used to derive the cap rate. In the words of the court,

> "Taxpayers' argument again assumes the use of the comparable sales method of deriving the capitalization rate. We have already concluded, however, that the assessor properly used the band-of-investment method to calculate the applicable capitalization rate. As we explained previously, under this method, the capitalization rate is derived by using a weighted average of the debt and equity for comparable properties. The inclusion or exclusion of interest subsidies and the proper valuation of mortgages is entirely irrelevant to this method." (p. 87)

Thus, even though the court never addressed the issue of low income housing credits (LIHC), it clarified the very narrow application of section 402.9 to 236 housing projects only, and to strict construction of the language in the statute.

Based on the foregoing case law and on the 1986 the adoption by Congress of the LIHC provisions in IRC Section 42 together with the repeal of the previous (i) accelerated depreciation, (ii) the 5-year amortization of rehabilitation expenses under IRC Section 167(k), and (iii) the expensing of interest and taxes, and (iv) the availability and benefits received from various deductions, the following conclusions may be drawn:

- First, Section 402.9 is not applicable to projects valued under Rule 8 and the band-of-investment method of deriving the capitalization rate. Cash equivalency is relevant only to the comparable sales approach in Rule 4.

- Secondly, Section 402.9 is not applicable to projects with allocated LIHC under IRC Section 42 for the following reasons:

(a) It was adopted in 1978, long before Congress passed the tax credit system (LIHC) consolidated in IRC Section 42 with the repeal the earlier tax incentive provisions in 1986;

(b) As discussed in some detail above, LIHC is not an "interest subsidy payment" described under 402.9, but is the major component in present worthing the income stream of all low income housing projects;

(c) In applying the income method (the preferred method of valuation for these properties) under Rule 8(g), the band-of-investment method is proper for determining the cap rate, since it is the same method by which the investors in low income housing projects with LIHC calculate their rate of return.[12] Accordingly, the assessor should establish the present worth of the future income stream of a housing project which is allocated LIHC, by considering (among other factors) both the rental income at its restricted rate (pursuant to the authority of Section 402.1), as well as the amount of the LIHC allocated to the project. The reality of the credit system for low income housing projects under IRC Section 42 is that the anticipation of income from such projects in the marketplace is based on these two factors (the primary one being the LIHC);

- Thirdly. Section 402.9 is applicable only to 236 projects without allocated LIHC and in a manner consistent with our previous Letters to Assessors and the *Mission Housing* case;

- Fourthly, Rule 8 requires and section 402.9 does not preclude the capitalization of all net benefits of all types of low income housing projects, including the benefits of LIHC.

Given the recent questions received from various assessors and the changes in the law, revised advice based on these conclusions would be appropriate.

KEC:ba
Attachments:

cc: Mr. Larry Augusta

precednt\miscelan\1998\98003.kec

[12] Ibid., "The Tax Magazine."

APPENDIX

Valuation of Older Low Income Housing Projects

Example: Taxpayer purchases an older structure which qualifies for the 20% rehabilitation credit for $2,000,000, of which $200,000 is allocable to the land. Taxpayer thereupon expends $3,000,000 on qualified rehabilitation expenditures, converting the building into an apartment project, and claims the 20% rehab credit. In addition, Taxpayer rents 40% of the project to low-income tenants, as defined for purposes of the low-income housing credit, and otherwise qualifies the project for the low-income housing credit.

The annual tax benefits for which the project with both rehabilitation credit and low-income housing credits are as follows:

Amount of One-Time Credit:		
Rehabilitation Credit:		
($3,000,000 x 20%)		$600,000
Amount of Annual Credit:		
Low-Income Housing Credit Acquisition:		
$1,800,000 x 40% x 4%	$ 28,800	
Rehabilitation:		
$3,000,000 - 600,000 =		
$2,400,000 x 40% x 9%	86,400	
Total Annual Credit	$115,200/yr.*	
Amount of Annual Depreciation Benefit:		
$4,800,000 - 600,000 =		
$4,200,000 ÷ 27,5 x 28%	$ 42,764/yr.	
Total Annual Benefit		$157,964

If, the annual tax benefit on same project of which only low income housing applies is as follows::

Amount of Annual Credit:	
Acquisition:	
$1,800,000 x 40% x 4%	$ 28,800
Rehabilitation:	
$3,000,000 x 40% x 9%	108,000
Total Annual Credit	$136,800/yr.

Amount of Annual Depreciation Benefit:		
$4,800,000 ÷ 27.5 x 28%	$ 48.8743	
Total Annual Benefit		$185,673

Thus, the cost to Taxpayer of claiming the rehabilitation credit was a reduction in tax benefits of $27,709 per year for 10 years. The benefit, however, of an additional first-year credit of $600,000 would more than offset the discounted present value of $27,709 in annual loss of benefits over a 10-year period.[1]

[1] "Tax Management," Portfolio No. 477, *Rehabilitation Tax Ciredit and Low-Income Housing Tax Credit, p. A-58, A-59.*

Cost Segregation Studies Improve Investor Yields in Low-Income Housing Tax Credit Projects

Michael J. Novogradac demonstrates the potential increase in the internal rate of return that results when project costs are segregated and depreciated over each applicable recovery period.

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In calculating a low-income housing tax credit (LIHC)[1] project's internal rate of return (IRR), corporate investors often assume that the entire depreciable basis will be recovered over the depreciable life of the building. This translates into a depreciable life of either 27.5 or 40 years, depending on the investment partnership structure. Corporate investors can improve their anticipated IRR by segregating project costs and depreciating each cost over its applicable recovery period. Segregating project costs among building, site improvements, and personal property, and depreciating each cost accordingly, will usually significantly accelerate depreciation deductions. This acceleration of depreciation deductions will generally accelerate tax savings and generate a higher IRR. In lieu of enhanced yields, LIHC developers

[1] A detailed discussion of the low-income housing tax credit is beyond the scope of this article. For a detailed discussion regarding the low-income housing tax credit, see Novogradac & Company LLP, LOW-INCOME HOUSING TAX CREDIT HANDBOOK (Clark, Boardman, Callaghan 1996).

can use cost segregation studies to increase tax losses and, as such, increase the amount of capital invested by their partner/investor.

— IRR Calculation

The IRR calculation is theoretically composed of three major items:

(1) the low-income housing tax credit;[2]
(2) cash flow from operations (and sale) of the project; and
(3) the tax benefit (cost) of taxable losses (income).

In an LIHC project, the predominant tax benefit is the credit itself. Investors rarely expect that they will receive any cash flow, so cash flow is generally omitted from the IRR calculation. This leaves tax losses as the last significant component of yield. As such, tax losses are a smaller but significant portion of the investor's yield. Furthermore, over the last few years credit prices have been rising, forcing investor yields to fall. As investor yields fall, the portion of the yield attributable to tax losses increases, increasing the importance of cost segregation studies.

The increase in the number of tax-exempt bond LIHC projects has also raised the importance of cost segregation studies. In a tax-exempt bond LIHC project, the tax credits generated are less than half the credits available in most taxable bond projects.[3] Tax-exempt bond LIHC developers are willing to take the reduction in tax credits because they achieve a lower interest rate on the tax-exempt bonds they use to finance the development.[4] Nonetheless, in such a transaction, the importance of the tax losses, as a function of the tax credits, is more than twice that of a taxable bond development.

The IRR calculation is made on an after-tax basis and generally is calculated on a quarterly basis. The quarterly-based calculation is used because corporate investors are required to make estimated tax payments on a quarterly basis. As such, corporations are able to realize the cash flow savings from the tax benefits of an LIHC investment on a quarterly basis as they lower their quarterly estimated tax payments.

Before and After Comparison

The following example demonstrates the potential increase in the IRR when project costs are segregated and depreciated accordingly. For comparison purposes, we have analyzed the effects of cost segregation on both a for-profit and a nonprofit ownership structure. We have also analyzed the effects on both a taxable and tax-exempt bond transaction. Our assumptions are as follows:

1. Project costs of $8,750,000 (includes land and depreciable assets).
2. Total tax credits allocated to limited partners: $6,740,542 ($2,866,000 for the tax-exempt bond project).
3. Bank loan of $3,850,000 at 8.65% interest ($5,950,000 at 6.25% interest for the tax-exempt bond project), amortized ratably over 30 years.
4. Limited partner contribution in Year One of $4,125,000 ($2,000,000 for the tax-exempt bond project).
5. Taxpayer is on the accrual basis.
6. In the first year of stabilized occupancy, net operating income is $481,517.
7. Debt service is $30,013 monthly (tax-exempt debt service is $36,635 monthly).
8. Limited partners assume no cash distributions for internal rate of return calculations.
9. Income increases at 2% a year. Expenses increase at 3% a year.
10. Stabilized vacancy at 5%.
11. Effective federal and state income tax rate of 40%.

[2] For acquisition/rehabilitation developments, historic tax credits may also be available. See IRC Sec. 48(g).

[3] Richard S. Goldstein and Herbert F. Stevens, "Tax Credits With Tax-Exempt Bonds—The Not-So-Automatic Credits," 7 *LIHC Monthly Report* 3 (Michael J. Novogradac, 1996).

[4] A detailed discussion of tax-exempt bonds is beyond the scope of this article. For a detailed discussion regarding tax-exempt bonds, see Novogradac & Company LLP, LOW-INCOME HOUSING TAX-EXEMPT BOND HANDBOOK (Novogradac & Company LLP 1996).

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Scenario	I	II	III	IV
Ownership type	100% For-profit (9% Credit)	100% For-profit (9% Credit)	100% Non-profit (9% Credit)	100% Non-profit (9% Credit)
Cost-Segregation	No	Yes	No	Yes
Depreciation				
Building	100% / 27.5 yrs	82% / 27.5 yrs	100% / 40 yrs	82% / 40 yrs
Site Improvement		12% / 15 yrs		12% / 20 yrs
Personal Property		6% / 7 yrs		6% / 10 yrs
IRR	15.00%	16.08%	13.99%	14.74%
Syndication proceeds	$4,125,000	$4,289,000 at 15.00% Yield	$4,125,000	$4,250,000 at 13.99% Yield

Scenario	V	VI	VII	VIII
Ownership type	Tax-Exempt 100% For-profit	Tax-Exempt 100% For-profit	Tax-Exempt 100% Non-profit	Tax-Exempt 100% Non-profit
Cost-Segregation	No	Yes	No	Yes
Depreciation				
Building	100% / 27.5 yrs	82% / 27.5 yrs	100% / 40 yrs	82% / 40 yrs
Site Improvement		12% / 15 yrs		12% / 20 yrs
Personal Property		6% / 7 yrs		6% / 10 yrs
IRR	15.00%	17.67%	12.76%	14.42%
Syndication proceeds	$2,000,000	$2,165,500 at 15.00% Yield	$2,000,000	$2,125,000 at 12.76% Yield

The above example demonstrates how the proper segregation of costs can increase annual depreciation expense and, as a result, may increase taxable losses and the project's IRR. The example demonstrates that for both the for-profit and the non-profit ownership structure, the IRR can increase somewhere between 5.4 percent and 7.2 percent (from 15.00 percent to 16.08 percent for a for-profit, 9 percent tax credit project and from 13.99 percent to 14.74 percent for a non-profit, 9 percent tax credit project). In the example above, this increase in yield could be translated into an increase in syndication proceeds of about $164,000 on a for-profit, 9 percent transaction and $125,000 on a non-profit, 9 percent project. The actual increase in the IRR will vary according to the relative cost of the three major components of depreciable property: building, site improvements, and personal property. The potential increase in syndication proceeds will similarly vary.

For the tax-exempt, for-profit project, yields jump 17.8 percent (from 15.00 percent to 17.67 percent) which translates to $165,000 of extra syndication proceeds at a 15 percent yield. For the tax-exempt, non-profit project, yields jump 13 percent (from 12.76 to 14.42 percent) which translates to $125,000 of extra syndication proceeds at the 12.76 percent yield. Generally, as the amount of depreciable property increases, the capital that will be invested by potential investors will increase.[5]

It is worth noting that in calculating the potential increase in syndication proceeds, it is assumed that the increased equity is used to pay a nondeductible expense. To the extent that the increased fee generates additional deductions, an iterative calculation results: that being an increase in losses generating a smaller increase in tax benefits and the increased tax benefits generating increased equity and so forth.

[5] Michael J. Novogradac and Stephen B. Tracy, "Treatment of Land Preparation Costs in a Low-Income Housing Tax Credit Development," 23 *J. Real Est. Tax'n.* 156 (Winter, 1996).

Although the method of segregating costs is the same for both the for-profit and the non-profit ownership structure, the non-profit ownership structure is required to use longer depreciable lives for the building, site improvements and personal property.[6] As seen in the example above, the depreciable life requirements for property owned via a non-profit structure are longer than those of the for-profit structure. Both entities will see increases in the IRR when a cost segregation study is used in computing the IRR.

Segregation of Depreciable Costs

The segregation of depreciable costs to building, site improvements, and personal property will vary depending on the particular circumstances within a particular low-income housing project. The relative percentage of costs allocated to building, site improvements, and personal property can vary greatly across different types of developments.

Categorizing Costs

Building costs to be capitalized and depreciated generally include direct costs [7] and indirect costs [8] incurred during the construction of the property. Direct costs may include labor, materials, equipment, and subcontractors fees. Indirect costs may include construction loan interest, insurance, permit and license fees, taxes, architectural and legal fees, accounting fees, and builder's profit and overhead.

Site improvements to be capitalized and depreciated generally include improvements made directly or indirectly to the land, provided such improvements are subject to wear and tear over time. Generally, most of the costs associated with site preparation, walkways, paving, and landscaping are depreciable by virtue of the fact that they are a wasting asset.[9]

Personal property costs to be capitalized and depreciated include furniture, fixtures and equipment such as carpets, refrigerators, dishwashers, washers and dryers.

Nondepreciable Costs

The emphasis of this article is on depreciable costs because depreciable costs reflect the greater portion of cost recovery items in an LIHC investment. Furthermore, the majority of the costs included in depreciable basis are also included in eligible basis for purposes of calculating the annual LIHC a project will generate.

However, LIHC investors and developers should also review cost segregation as it applies to nondepreciable costs. Namely, attention should be given to properly apportioning nondepreciable costs among other assets, some of which are subject to amortization. The major amortizable costs found in a LIHC project are:

1. loan fees;
2. organization costs;[10] and
3. start-up costs.[11]

Loan fees are amortized over the life of the loan. Organization costs and start-up costs are amortized over five years, if the proper tax elections are made.

Conclusion

Although the administrative costs and the financial benefits of performing a cost segregation study will vary depending on the particular circumstances within a low-income housing project, the financial benefits will generally outweigh the administrative costs. Both corporate investors in and real estate developers of LIHC projects should consider the benefits of performing a cost segregation study.

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[6] See IRC Sec. 168(g)(1)(B) regarding tax-exempt use property.
[7] IRC Sec. 263A(a)(2)(A).
[8] IRC Sec. 263A(a)(2)(B).
[9] Novogradac & Company LLP, Low-Income Housing Tax Credit Handbook at 113 (Clark, Boardman, Callaghan 1996).
[10] IRC Sec. 709.
[11] IRC Sec. 195.

TAX TACKS

Internal Use Software and the Research Credit

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Officially, the topic of what qualifies for the research credit under Section 41[1] should be viewed as a moot point right now. The research credit expired on May 31, 1997. Given, however, that tax legislation appears likely this year and that both the House and Senate versions of the tax bill include an extension of the research credit, the availability of the research credit for software development remains a fairly hot topic.

Section 41(d)(4)(E) provides the following with respect to activities for which the research credit is not allowed:

> Computer Software.—Except to the extent provided in regulations, any research with respect to computer software which is developed by (or for the benefit of) the taxpayer primarily for internal use by the taxpayer, other than for use in—

[1] Unless otherwise indicated, all statutory references are to the Internal Revenue Code of 1986, as amended (the "Code").

(i) an activity which constitutes qualified research (determined with regard to this subparagraph); or

(ii) a production process with respect to which the requirements of paragraph (1) are met.

Paragraph (1) refers to the definition of "qualified research" as research which is undertaken for the purpose of discovering information which is technological in nature, the application of which is intended to be useful in the development of a new or improved business component of the taxpayer, and substantially all of the activities of which constitute elements of a process of experimentation for a purpose of a new or improved function, performance or reliability, or quality.

On December 31, 1996, the IRS promulgated proposed regulations pursuant to the direction in the above quoted statutory language.[2] The proposed regulations utilize a facts and circumstances test to evaluate the internal use software under tests of being innovative in nature, involving significant economic risk, and not being commercially available. The facts and circumstances analysis is to be applied only to the development of new or improved software independent of the effect of any modifications on related hardware or other software, and only if the software meets a high threshold of innovation. The proposed regulations also clarify that internal use software is eligible for the credit where it is developed for use under the two specific criteria listed in the statute—in an activity or as part of a production process that otherwise qualifies for the research credit. The proposed regulations also state that software and hardware developed together as a single product to provide technological services to a taxpayer's customers are to be evaluated as a single product. The software is not to be subjected to the facts and circumstances test separately.

Practitioners have generally been concerned that the proposed regulations leave too much to interpretation and provide little guidance so that taxpayers can feel confident in claiming the research credit on any particular software development project. The concern has been highlighted by the recent *United Stationers* case.[3] The issue in this case, decided on March 18, 1997 by the U.S. District Court for the Northern District of Illinois, was whether seven internal use computer programs developed by a large office products wholesaler met the requirements of being innovative and developed at significant economic risk (the fact they were not commercially available was conceded). The programs served to automate and computerize the taxpayer's business operations, including document retention and retrieval; central invoicing; order entry; inventory records, forecasting and replenishment; and automated shipping.

The court held that the computer programs were not innovative. They were found to have "simply increased efficiency and revenues for Plaintiff." and did not create a revolutionary new way to organize business such that the "efficiency or productivity of the market would be greatly affected." Second, the court said that the development of the programs did not involve an economic risk, stating that improved internal efficiency "does not elevate internal use software into a market enhancing product." The focus of the court on the lack of external importance of the software has raised significant concerns that a requirement that internal use software have external significance serves to reduce the Section 41(d)(4)(E) exception to nothing. The Tax Executives Institute has cited evidence that IRS field agents are touting the *United Stationers* decision around the country for just such a requirement of external importance.

If the proposed regulations are to meaningfully preserve a research credit for internal use software, it is felt that they must be more concrete in providing better definitions and examples of what is meant by "innovative," "not commercially available" and "significant economic risk." The additional requirement that the software meet "a high threshold of innovation" appears to suggest that it is not enough to be merely "innovative," perhaps setting a higher threshold for computer software than otherwise required for the research credit under Section 41.

The court in *United Stationers* referred to the fact that the scope and applicability of the research credit remains ambiguous in spite of the statutory criteria and exclusions. The court also referred to the dearth of case law in the area. Many practitioners feel that the proposed regulations do not serve to meaningfully fill that gap. Hopefully, the final regulations will.

[2] Prop. Reg. § 1.41-4(e).

[3] *United Stationers, Inc. v. U.S.*, 97-1 USTC ¶ 50,457.